

# UK Court Sheds Light On De Facto And Shadow Directors

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In *Smithton Ltd. v. Naggar*,<sup>1</sup> the UK Court of Appeal has further delineated the boundaries between the board of a company and its shareholders. The judgment is instructive of the English courts' current approach to defining the role of director, as well as addressing a question that often arises in practice—whether a director of a holding company is also a director of its subsidiary. Whilst the decision reminds us that it is what someone actually does rather than job titles that matters, it might also provide some reassurance that investors' active stewardship of portfolio companies will not necessarily result in board-level responsibility.

## When is Someone a Director?

This is a crucial question in light of the myriad statutory and common law duties incumbent on directors, including their potential personal liability when things go wrong. As per Section 250 of the Companies Act 2006, a "director" includes any person occupying the position of a director, by whatever name called.

Under English law, there are three classes of director: de jure, de facto and shadow directors. A de jure director is one who is formally appointed as director in accordance with a company's constitutional documents. A de facto director exercises the duties of a director but is not formally appointed.<sup>2</sup> A shadow director is defined in Section 251 CA as a person in accordance with whose directions or instructions the directors of a company are accustomed to act.<sup>3</sup>

<sup>1</sup> *Smithton Ltd. (formerly Hobart Capital Markets Ltd.) v. Guy Naggar* [2014] EWCA Civ 939

<sup>2</sup> Prior to the 1980s, the term "de facto director" was used in cases where the appointment requirements had not been complied with or where someone ceased to be a formal director. Since then, the definition has expanded to include those who hold themselves out as director (*Re Hydrodam (Corby) Ltd.* [1994] 2 BCLC 180). At present, the leading case on the matter is the Supreme Court decision in *HMRC v. Holland* [2010] 1 WLR 2793, which considers the acts of the director and whether the acts fall within the ambit of the director's duties.

<sup>3</sup> However, a person is not deemed a shadow director by reason only that the directors act on advice given by him in a professional capacity.

The case of *Smithton* provides insight on factors the court will take into account when determining the existence of a de facto directorship. The issue in the case was whether Naggar, a de jure director of a former holding company (DDI), was also the de facto director of its subsidiary joint venture brokerage company, Hobart, and had subsequently infringed his directorial duties. At trial as on appeal the issue of de facto and shadow directors was dealt with simultaneously with the former being given greater consideration as befitting the facts of the case.

### **First Instance**

The High Court held that Naggar was not a de facto or shadow director of Hobart because he was acting at all times in a different capacity or wearing a different "hat" from that of a director of Hobart. Whilst it was not disputed at trial that Naggar's conduct was "directorial" in nature, it was held that, when considered objectively, such conduct was also capable of being attributed to his other roles as chairman of the majority shareholder or as a major client, and furthermore that, in fact, Naggar had acted in such other capacity.

In support of her finding of fact, the judge at first instance referred to the existence of a detailed joint venture agreement (JVA) which, among other things, included a schedule of reserved matters requiring the consent of the majority shareholder and prescribed the constitution of Hobart's board.

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Significantly, the JVA did not provide for Naggar to be a director of Hobart. It was also found that in its dealings with third parties, including regulatory authorities, Hobart had never held out Naggar as one of its directors and there was no evidence that a majority of Hobart's board was accustomed to act in accordance with Naggar's instructions. Furthermore, the court noted that Naggar had not held himself out as a director and had never attended board meetings.

### **Court of Appeal**

The Court of Appeal was not persuaded to set aside the High Court's judgment that Naggar had not been involved in Hobart's affairs in the capacity as a director of Hobart and unanimously dismissed Hobart's appeal. The court referred to the leading case of *Holland*.<sup>4</sup> In that case, the Supreme Court (by a majority of three) decided that a director of a corporate director, which was the sole director of 43 trading subsidiaries, was not a de facto director of the trading

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<sup>4</sup> *HMRC v. Holland* [2010] 1 WLR 2793

subsidiaries, as the director had only acted "within his ambit" as a director of the corporate director.

The Court of Appeal in *Smithton* adopted the capacity-based approach in *Holland*,<sup>5</sup> determining "capacity" is a matter of assessing the evidence taking into account all the circumstances, and the Court of Appeal was not prepared to overrule the High Court's findings in that regard.

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Lady Justice Mary Arden, giving the main judgment in *Smithton*, specifically cited Lord Collins' holding in *Holland* that there is no definitive test for a de facto director. She did however identify a number of points arising out of *Holland* and previous cases, which she described as being of general practical importance in determining who is a de facto director:

- The concepts of shadow director and de facto director are different but there is some overlap.
- A person may be a de facto director even if there was no invalid appointment. The question is whether he had assumed responsibility to act as a director.
- To answer that question, the court may have to determine in what capacity the director was acting (as in *Holland* and *Smithton*).
- The court will in general<sup>6</sup> also have to determine the corporate governance structure of the company so as to decide in relation to the company's business whether the individual's acts were directorial in nature.
- The court is required to look at what the director actually did and not any job title actually given to him.
- A defendant does not avoid liability if he shows that he in good faith thought he was not acting as a director. The question whether or not he acted as a director is to be determined objectively and irrespective of the defendant's motivation or belief.
- The court must look at the cumulative effect of the activities relied on and at all the circumstances in the round.

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<sup>5</sup> Lord Collins was conscious of the principle of separate legal personality in English corporate law and did not want to impose fiduciary or legal duties on a director whose acts were only referable to a corporate director and not the trading subsidiaries. The dissenting judgments in *Holland*, namely that of Lord Walker, felt that this enabled individuals to use artificial corporate structures to evade liability to the detriment of unsecured creditors; especially when in substance the director is the only 'person' running the show. Perhaps due, in part, to the *Holland* case, there is currently a bill before Parliament which, if it becomes law, would prevent the appointment of corporate directors (clause 76, Small Business, Enterprise and Employment Bill 2014).

<sup>6</sup> As noted above, this was less relevant in *Smithton* because the defendant had accepted that his conduct was "directorial" in nature.

- It is also important to look at the acts in their context. A single act might lead to liability in an exceptional case.
- Relevant factors include:
  - Whether the company considered the defendant to be a director and held him out as such; and
  - Whether third parties considered that he was a director.
- The fact that a person is consulted about directorial decisions, or that his approval is sought, does not in general make him a director because he is not making the decision.
- Acts outside the period when he is said to have been a de facto director may throw light on whether he was a de facto director in the relevant period.
- A de facto or shadow director's role need not cover all a company's activities.
- Whether a person is a de facto or shadow director is a question of fact and degree.

## Conclusion

The Court of Appeal's judgment in *Smithton* would appear to support the view that a person acting like a director will not necessarily be a director; to be so, there must be sufficient evidence to establish that, in fact, a person was acting in the capacity of director and not in a different capacity. That said, in the absence of a clear judicial test to answer the question—when is someone a director—the risks of ambiguous or informal corporate governance structures, where roles are blurred, is self-evident.

Cases like *Smithton* and *Holland* remind us of the importance of effective corporate governance structures, supported by detailed constitutional documents that set out the often overlapping yet distinct roles and responsibilities of directors, investors and other key players, with regular board meetings that are properly minuted to record what was decided, by whom and in what capacity.

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